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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF HAWAII

In the Matter of the Application of)) KAUAI ISLAND UTILITY COOPERATIVE)) For approval to commit funds in excess of $500,000 for the purchase of the Kauai Power Partners facility and related matters.)	DOCKET NO. 03-0223

DECISION AND ORDER NO. 20691

RECEIVED
2003 NOV 28 P 4:06

Filed Nov. 26, 2003

At 2:45 o'clock p.M.

Brooke K. Nagaji

for Chief Clerk of the Commission

ATTEST: A True Copy
BROOKE K. NAGAJI
Administrative Director
Public Utilities Commission
State of Hawaii

B. Nagaji

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In the Matter of the Application of)) KAUAI ISLAND UTILITY COOPERATIVE)) For approval to commit funds in) excess of $500,000 for the purchase) of the Kauai Power Partners) facility and related matters.))	Docket No. 03-0223 Decision and Order No. 20691

DECISION AND ORDER

I.

PROCEDURAL HISTORY

KAUAI ISLAND UTILITY COOPERATIVE ("Applicant" or "KIUC") requests a commission order: (1) approving the commitment of funds, as described in its Application,[1] to purchase a 26.4 megawatt ("MW") combustion turbine electric generation facility and related assets (collectively, the "KPP Facility") owned by Kauai Power Partners, LP ("KPP")[2]; (2) approving the proposed financing arrangements to be obtained by Applicant for the purpose of acquiring the KPP Facility; (3) terminating or otherwise deeming satisfied the regulatory conditions set forth in Decision and Order No. 16396, filed on June 29, 1998 and Decision and Order No. 18388, filed on February 23, 2001, in Docket No. 97-0213; and (4) stating that

[1]Application filed on August 18, 2003.

[2]The KPP Facility being defined as "Assets" in that certain Purchase and Sale Agreement dated as of July 30, 2003, a copy which is attached to the Application as Exhibit A.

the order issued in Decision and Order No. 18659, filed on June 29, 2001, in Docket No. 97-0213, is no longer applicable following the purchase of the KPP Facility by Applicant.[3]

Applicant served copies of the Application on the Department of Commerce and Consumer Affairs, Division of Consumer Advocacy ("Consumer Advocate"). On August 28, 2003, the Consumer Advocate served Informal Information Requests upon Applicant. On September 15, 2003, the Consumer Advocate served its First Submission of Information Requests upon Applicant. On September 17, 2003, KIUC responded to the Consumer Advocate's Informal Information Requests and First Submission of Information Requests. On September 22, 2003, KIUC submitted its confidential response to a portion of Attachment CA-IR-1(a) and Attachment CA-IR-21, part 1. On September 26, 2003, the Consumer Advocate served its Second, Third, and Fourth Submission of Information Requests to KIUC. On September 30, 2003, KIUC filed its Supplemental Responses to the Consumer Advocate's First Submission of Information Requests (CA-IR-45) and Responses to the Consumer Advocate's Second, Third, and Fourth Submissions of Information Requests. On October 9, 2003 KIUC filed its Supplemental Response to the Consumer Advocate's Fourth Submission of Information Requests (CA-IR-94). On October 13,

[3]On August 27, 2003, KIUC submitted revised Exhibit E of the Application, for clarification, amending Section E of its Application. On September 26, 2003, KIUC submitted a revised Exhibit H of the Application. On October 6, 2003, the commission approved Applicant's waiver of the 90-day review period by which the commission must issue a decision and order, pursuant to Section 2.3.g.2 of General Order No. 7. See Order No. 20556, filed on October 6, 2003.

2003, the Consumer Advocate filed its Fifth Submission of Information Requests. On October 15, 2003, KIUC responded to the Consumer Advocate's Fifth Submission of Information Requests. On October 27, 2003, KIUC filed its Supplemental Response to the Consumer Advocate's Fourth Submission of Information Requests (CA-IR-96). On October 27, 2003, the Consumer Advocate filed its Statement of Position. On October 31, 2003, KIUC filed its Information Requests on the Consumer Advocate. On November 5, 2003, KIUC filed its Second Supplemental Response to the Consumer Advocate's Fourth Submission of Information Requests (CA-IR-96). On November 7, 2003, the Consumer Advocate filed its Response to KIUC's Information Requests. On November 12, 2003, KIUC filed its Rebuttal Statement to the Consumer Advocate's Statement of Position.

II.

BACKGROUND

Applicant is an operating public utility engaged in the production, transmission, distribution, purchase and sale of electric energy on the island of Kauai, State of Hawaii. Applicant currently purchases electrical energy and firm generation capacity from KPP, a Delaware limited partnership, pursuant to that certain Amended and Restated Power Purchase

Agreement ("PPA") dated July 27, 1998, as amended.[4] The KPP Facility is located at the Lihue Energy Service Center on the island of Kauai on lands owned by Applicant, upon which Applicant has granted to KPP a ground lease for the use and operation of the KPP Facility.

Pursuant to the Purchase and Sale Agreement ("Agreement") dated as of July 30, 2003, Applicant and KPP have entered into an agreement allowing for the purchase of the KPP Facility by Applicant. Under the terms of the Agreement and upon satisfaction of certain conditions precedent[5] including, but not limited to, the commission's approval of this Application, Applicant and KPP will terminate the PPA and the aforementioned ground lease and transfer to Applicant the KPP Facility including, but not limited to, any transferable permits and contracts required to own and/or operate the KPP Facility and the rights to any transferable warranties pertaining to the KPP Facility. Applicant will then assume the "Assumed

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[4]The commission initially approved the PPA in Decision and Order No. 16396, filed on June 29, 1998, in Docket No. 97-0213. Pursuant to Decision and Order No. 18358, filed on February 6, 2001, as amended by Decision and Order No. 18388, filed on February 23, 2001, the commission approved certain amendments to the PPA. In addition, pursuant to Decision and Order No. 18659, filed on June 29, 2001, the commission approved certain amendments to Decision and Order No. 16396.

The PPA, as amended, was originally entered into between KPP and Citizens Communications Company ("Citizens"), but was assigned by Citizens to KIUC in connection with Applicant's purchase of Citizens' Kauai Electric Division assets and operations on November 1, 2002. See Decision and Order No. 19658, filed on September 17, 2002, in Docket No. 02-0060.

[5]See Articles VIII and IX of the Agreement (Exhibit A).

Liabilities" (as defined in Section 2.3 of the Agreement) including, but not limited to, the rights and obligations under any such permits and contracts that may be assigned to Applicant.

The base purchase price of the KPP Facility is $40.2 million,[6] increased by $423,000 to settle certain outstanding PPA invoices, $474,000 to retire the capital lease on the reverse osmosis feed water treatment system, and $650,000 in transaction costs, for a total acquisition cost of $41.75 million.[7] Applicant currently intends to finance $41.2 million of the purchase price[8] and fund any remaining amounts due under the Agreement directly with cash.

III.

ISSUES

The issues in this proceeding are:

(1) Whether the proposed commitment of funds for the purchase by Applicant of the KPP Facility should be approved, pursuant to Section 2.3.g.2, of the commission's General Order No. 7;

(2) Whether the proposed financing arrangements to be obtained by Applicant for the purpose of acquiring the KPP Facility should be

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[6]See Section 3.1 of the Agreement (Exhibit A).

[7]Excluding the cost of fuel and spare parts inventories. See Response to CA-IR-2 and Article II of Exhibit A.

[8]See Section E of the Application.

approved pursuant to Hawaii Revised Statutes ("HRS") §§ 269-17 and 269-19;

(3) Whether the regulatory conditions set forth in Decision and Order No. 16396 and Decision and Order No. 18388 should be terminated or otherwise deemed satisfied following the purchase of the KPP Facility by Applicant;

(4) Whether the order issued in Decision and Order No. 18659 should no longer be applicable following the purchase of the KPP Facility by Applicant; and

(5) Whether any other relief as may be just and reasonable should be granted under the circumstances.

IV.

DISCUSSION

A.

Whether the proposed commitment of funds for the purchase by Applicant of the KPP Facility should be approved pursuant to Section 2.3.g.2 of the commission's General Order No. 7.

The Consumer Advocate does not dispute that the KPP Facility acquisition is required for utility purposes. However, the Consumer Advocate's analysis on this matter focused on the reasonableness of the proposed transaction. To determine the reasonableness of the proposed transaction, the Consumer Advocate considered the financial benefits of the acquisition and the purchase price of the KPP Facility.

1.

Financial Benefits

KIUC's primary justification for paying $41.75 million to acquire the KPP Facility is that such payment is substantially less than the present value of the avoided capacity charges in the PPA less KIUC's fixed costs to operate the plant, summed over the plant's remaining life[9] ("Simplified Cash Flow Model"). Based on its projections, KIUC represents that it would save more than $39 million through the end of 2027 even after incurring direct operating costs as the owner of the KPP Facility instead of making capacity payments under the PPA and after making principal and interest payments on the acquisition financing.[10]

According to KIUC, the difference between the total acquisition price and the present value of the net cash flows that are anticipated with the proposed acquisition is sufficiently large to produce meaningful benefits for customers and/or members after taking into account the incremental risks of ownership that result from terminating the PPA. The Consumer Advocate prepared Attachment A to its Statement of Position to evaluate the incremental financial impact expected from the acquisition of the KPP Facility. The Consumer Advocate used KIUC's avoided capacity payments, estimated KPP's fixed operating costs and estimated KIUC's cost of capital at 5 per cent. The present value of the incremental net cash flow, exclusive of

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[9]See Application Exhibit C, "KPP Valuation on [Net Present Value ("NPV")] of Cash Flows."

[10]See Application at 6-7 and Exhibit C to the Application, "KPP Valuation on NPV of Cash Flows."

acquisition financing costs, equals $58.2 million over 25 years under this approach.

The Consumer Advocate agrees with KIUC's conclusion that the acquisition produces tangible financial benefits to its customers and/or members when one takes into account KIUC's lower weighted average cost of capital. We agree and find the acquisition is financially beneficial to KIUC's customers and/or members.

2.

Purchase Price

KIUC was guided in its negotiations by a $42.185 million replacement cost estimate provided by Burns & McDonnell, an engineering and consulting firm retained by KIUC to assist in performing due diligence activities and to develop an independent replacement cost estimate for the KPP Facility. After considering the capitalized costs that an owner of a generating facility would incur for permitting, interest during construction, and legal fees (which were excluded from the Burns & McDonnell analysis), KIUC estimates that it would have to incur a cost of at least $48 million to construct the KPP Facility and obtain all necessary approvals for its operations.[11]

Burns & McDonnell did not consider the market approach to value the KPP Facility due to the lack of sales transactions

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[11]See Application at 7 and Exhibit D.

involving similar assets on which to base comparisons to the KPP Facility. In addition, Burns & McDonnell did not perform the income approach to value the KPP Facility because there was insufficient accounting data available for use in projecting the fuel input, generation output, and operation and maintenance expenses due to the limited period of operation of the fairly new facility.

The Consumer Advocate modified the Simplified Cash Flow Model developed by KIUC to reflect the costs and revenues of KPP rather than KIUC.[12] This analysis replaced the fixed operating costs under KIUC ownership with the fixed costs being incurred under continued KPP ownership and by using an 8.74 per cent discount rate instead of the 5 per cent discount rate (a generalized industry average cost of capital, rather than KIUC's cost of capital). Based on research conducted by KIUC, 8.74 per cent is the average cost of capital for a group of financially solvent publicly-traded Independent Power Producers ("IPPs") and a reasonable proxy for KPP's cost of capital.[13] With these input changes, the Simplified Cash Flow Model produces a NPV of $41.76 million.[14] The Consumer Advocate asserts that the $41.76 million can be interpreted as the minimum amount that KPP could reasonably be expected to accept for its assets.

[12]See Attachment B to the Consumer Advocate's Statement of Position.

[13]See response to CA-IR-111.

[14]See Attachment B to the Consumer Advocate's Statement of Position.

Alternatively, the $41.76 million value could be interpreted as the amount that other IPP owners would be willing to pay to acquire the KPP assets and assume the rights and obligations of ownership set forth in the existing PPA terms. Therefore, the Consumer Advocate concluded that KIUC did not pay above fair market value to acquire the KPP Facility, and found that the base purchase price and the total acquisition cost were reasonable.[15] We agree with the Consumer Advocate and find that Applicant's purchase price of the KPP Facility to be reasonable and consistent with the public interest.

B.

Whether the proposed financing arrangements to be obtained by Applicant for the purpose of acquiring the KPP Facility should be approved, pursuant to HRS §§ 269-17 and 269-19.

1.

HRS § 269-17 requires a public utility corporation to obtain our consent prior to issuing evidence of indebtedness having a maturity exceeding 12 months. This section permits the proceeds of such debt to be used only for the acquisition of property or for the construction, completion, extension, or improvement of or addition to Applicant's facilities or service, or for the discharge or refunding of its obligations or reimbursement of funds expended for the foregoing described purposes. We may approve the issuance of debt obligations if we

[15] See Consumer Advocate's Statement of Position at 12.

find that such an issuance will not have a material adverse effect on Applicant's public utility operations.[16]

2.

KIUC proposes two alternative financing arrangements for the proposed acquisition of the KPP Facilities employing interim bridge financing and then either: (1) a combination of United States Department of Agriculture, Rural Utility Service ("RUS") and National Rural Utilities Cooperative Finance Corporation ("CFC") permanent financing; or (2) only CFC permanent financing, if RUS funding is not received (collectively, "Proposed Financing Arrangements"). The debt service covenants and security pledge of KIUC property are expected to be in the same form recently approved by the commission for the debt financing used by KIUC to acquire Citizen's Kauai Electric Division's assets in Docket No. 02-0060.[17]

KIUC projected the financial results for the next ten (10) years under three scenarios: (1) a "Scenario 1" base case in which KPP assets are not acquired and the PPA remains effective; (2) a "Scenario 2" with Applicant's preferred combination of RUS and CFC financing to acquire the KPP assets; and (3) a

[16]HRS § 269-19 also requires a public utility corporation to obtain our consent prior to, among other things, mortgaging, encumbering, or otherwise disposing of its property.

[17]<u>See</u> Application at 11-12.

"Scenario 3" if KPP is acquired solely with CFC financing (aka, "all-CFC" financing scenario).

KIUC's projections indicated significantly improved financial results relative to the base case under either acquisition scenario, in terms of Net Income, Times Interest Earned Ratio ("TIER"), Debt Service Coverage Ratio ("DSCR"), Equity ratio percentages and cash buildup.[18]

Under Applicant's preferred RUS/CFC combination permanent financing or "Scenario 2", the 80 per cent RUS portion of total new debt in the amount of $32.96 million is estimated to cost KIUC a blended interest rate of 4.42 per cent across all maturities, while the other 20 per cent CFC portion of new debt in the amount of $8.24 million is at an estimated variable cost rate of 2.80 per cent. The overall cost of new debt under the preferred financing approach is 4.09 per cent.

With the "all-CFC" financing scenario or "Scenario 3", the higher 50 per cent mix of variable rate 2.80 per cent debt is employed and is blended with a 50 per cent weighting of fixed rate debt in various maturities to yield a weighted average overall cost rate of 3.90 per cent.

The CFC financing commitment for a bridge loan for 80 per cent and permanent loan for 20 per cent of the $41.2 million of needed financing has been secured and is set forth in Exhibit E to the Application. KIUC intends to employ variable

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[18] See Consumer Advocate's Statement of Position at 24 and Exhibit C Financial Planning Model at Schedule 1, comparing Scenario 1, 2, or 3.

rate CFC financing for up to 12 months, at which time one of the two permanent financing scenarios will be finalized and closed.

Interest rates on new debt proposed to finance the KPP Facility acquisition will not be fixed or determinable for up to 12 months while the bridge financing remains in place. Even after permanent financing is closed, 50 per cent of the new debt under "Scenario 3" remains variable rate debt. This exposes KIUC to the risk of increases in interest rate in the future.

A report by the Federal Reserve Bank of Philadelphia, published on May 20, 2003, predicts an approximate 44 basis point upward trend in the ten year treasury bond yield (a proxy for the RUS Federal Financing Bank rates) from the third quarter of 2003 through the second quarter of 2004, and approximately a 57 basis point upward move in the three-month treasury bill rate (a proxy for the CFC variable interest rates).[19]

Favorable economics associated with the acquisition of the KPP Facility produce an internal rate of return that exceeds 9 per cent under KIUC's incremental operating cost projections, which far exceeds any foreseeable increase in interest rates that may be borne by KIUC in the future.[20] Using more pessimistic

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[19]This report is based on projections from 32 and 31 independent professional economic forecasters, respectively, that provide a range of possible interest rates that may be expected at the closing of the variable and fixed interest rate loans.

[20]See Consumer Advocate's Statement of Position at 25.

assumptions for future operating costs,[21] Attachment C of the Consumer Advocate's Statement of Position reflects the achievement of an internal rate of return of 6.81 per cent. The Consumer Advocate concludes that if higher interest rates are encountered when the KPP acquisition is ultimately closed, or upon rollover of future maturities, there is considerable "cushion" to absorb such increases as indicated by the economics of the KPP Facility acquisition.

In addition, the Schedule 13 "Yield Curve" for the planned RUS debt reveals that the first two $8.24 million layers of debt with the lowest interest rates will not mature for five (5) years and ten (10) years respectively.[22] When considered with the maturities for currently outstanding Muni Rates RUS debt on the same Schedule 13, KIUC expects to have accumulated available cash to repay most or all of this debt at the scheduled maturity if then-prevailing interests rates are excessive.

3.

Upon review, we find that the proposed financing arrangements are for permissible purposes, as set forth under HRS § 269-17, and that the issuance of debt obligations, as described

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[21]The Consumer Advocate assumes higher KPP anticipated fixed Operating and Maintenance ("O&M") costs of approximately $300,000 to $400,000 per year. The Consumer Advocate assumes $300,000 in year one and escalated in each projected year thereafter. The Consumer Advocate also assumes a moderate worsening of overhaul interval assumptions, a 25 per cent increase over projections. These assumptions approximately add an additional $20 million in expenses through 2027.

[22]See Consumer Advocate's Statement of Position at 26.

above, are reasonable and will not have a material adverse effect on Applicant's public utility operations. We also find the proposed financing arrangements to be reasonable and in the public interest.

Thus, we conclude that the proposed financing arrangements should be approved pursuant to HRS §§ 269-17 and 269-19, subject to: (1) Applicant being authorized to select one of the two approved permanent financing scenarios, (2) the permanent financing is closed within twelve (12) months of the closing of Applicant's purchase of the KPP Facility, and (3) the interest rates at closing are no higher than 200 basis points (i.e. 2 per cent) above the applicable interest rates in the financial planning models for "Scenario 2" and "Scenario 3" set forth in Exhibit C of the Application.[23]

C.

Whether the regulatory condition set forth in Decision and Order No. 16396 and Decision and Order No. 18388 should be terminated or otherwise deemed satisfied following the purchase of the KPP Facility by Applicant.

Decision and Order No. 16396 approved the PPA between KIUC's predecessor (Citizens) and KPP, while Decision and Order No. 18358 as amended by Decision and Order No. 18388 approved certain amendments to the PPA. In Ordering Paragraph 5 of Decision and Order No. 16396 (Part VI, subpart 5) and in Ordering Paragraph 1 of Decision and Order No. 18388 (Part II, subpart 1), the commission imposed conditions on Applicant

[23]See Application at 17.

requiring that the commission and the Division of Consumer Advocacy be notified "within 10 days of any termination notices that may be issued by KPP, any problems that may arise in the performance of the PPA, and any force majeure condition that may be triggered under the PPA."

Upon the sale of the KPP Facility to Applicant, Applicant and KPP have agreed to terminate the PPA. As a result, Applicant believes that it is either no longer necessary for the above regulatory conditions to be imposed, or that the conditions have already been satisfied by Applicant and KPP entering into the Agreement and by Applicant filing this Application notifying the commission and the Consumer Advocate of Applicant's and KPP's intent to terminate the PPA immediately following approval of the subject transaction and closing of the sale of the KPP Facility to Applicant. Applicant seeks an order stating that the condition imposed in Ordering Paragraph 5 of Decision and Order No. 16396 and in Ordering Paragraph 1 of Decision and Order No. 18388 is terminated, or in alternative, that said condition has already been satisfied. The Consumer Advocate finds this request reasonable. We agree with the Consumer Advocate, and, therefore, conclude that Applicant has satisfied the regulatory condition imposed in Ordering Paragraph 5 of Decision and Order No. 16936 and in Ordering Paragraph 1 of Decision and Order No. 18388.

D.

Whether the order issued in Decision and Order No. 18659 should no longer be applicable following the purchase of the KPP Facility by Applicant.

Decision and Order No. 18659 allows Applicant to treat the KPP Facility as one of its own in the context of the Energy Rate Adjustment Clause ("ERAC"). In doing so, Applicant is allowed to temporarily retain the fuel savings resulting from the more efficient operation of the KPP Facility and to apply these savings toward the capacity payments owed to KPP, pursuant to the PPA, until new rates become effective following Applicant's next rate case.

Applicant believes that the approval granted by said Decision and Order No. 18659 would no longer be applicable or necessary because Applicant would actually become the owner of the KPP Facility. In that connection, Applicant seeks an order stating that the order issued in Decision and Order No. 18659 is no longer applicable following the purchase of the KPP Facility by Applicant.

The Consumer Advocate expressed concerns relating to this request because the KPP efficiencies are not recognized in the system heat rate now being used to determine fuel cost recovery through KIUC's ERAC cost recovery mechanism. The Company's ERAC is based on a fixed system heat rate that was established in a prior rate case. The fixed system heat rate is used to calculate the fuel costs that are recoverable through customer rates for a given level of utility kilowatt per hour ("KWH") sales. Any fuel cost savings realized through the dispatch of more efficient generation to meet a given customer load is retained by the utility. On the other hand, any additional fuel costs incurred as a result of the dispatch of less efficient generation to meet the same load are borne by the utility. Thus, the fixed system heat rate provides a financial incentive to the utility to meet customer loads at minimum generation costs.

In the case of KIUC, the Kauai Electric tariff that was adopted by KIUC in Docket No. 02-0060 included a system heat rate that was based on KIUC's 1995 company-owned generating system that was not as efficient as the KPP facility. The 1995 fixed system heat rate does not recognize the reduced fuel cost associated with the thermal efficiency improvements that have been realized with the commercial operation of the KPP Facility.

Notwithstanding the above-stated concerns, the Consumer Advocate does not object to the commission's approval of Applicant's request if KIUC agrees to submit an informational filing subsequent to the filing of the required depreciation study expected on or before July 1, 2004 that contains a projection of KIUC's calendar 2005 normalized operating income/margin forecast, projected 2005 balance sheet and rate base, projected 2005 TIER and DSC coverage ratios and projected cash flows, reflecting the effects of proposed new depreciation accrual rates and the acquisition of the KPP Facility. In addition, the Consumer Advocate requests an updated calculation of system heat rate values for use in administering the ERAC. The Consumer Advocate's proposed informational filing would provide information from which the financial implications of modifying the ERAC heat rate could be considered.

KIUC argues that any adjustment to the heat rate used for ERAC purposes and/or allowing revised depreciation rates to be used outside of the context of a general rate case should not be made without the benefit of reviewing all aspects of the operations of the utility. For example, any adjustment to the KPP's ERAC must appropriately consider the fact that KIUC will also incur additional costs and expenses as the new owner of the KPP Facility, such as, taking over operations and existing operators of the facility (with the exception of the plant manager), obtaining insurance, adjusting depreciation expense, and incurring the additional financial indebtedness to purchase the facility. In addition, KIUC argues that any such adjustment constitutes single-issue ratemaking. KIUC believes that its first rate review proceeding should occur at such time that KIUC has developed sufficient operating history so that the regulatory methodology and any adjustments in rates can be established based on examination of actual financial and operating data.

To address the Consumer Advocate's concerns, KIUC proposes to file its equity management plan upon its completion. On October 23, 2003, the KIUC Board adopted Resolution 34-03,[24] wherein the KIUC Board authorized KIUC's President and Chief Executive Officer and its management team to begin preparing an equity management plan for submittal by no later

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[24]See supplemental response to CA-IR-96 and/or Exhibit 5 to KIUC Rebuttal Statement.

than November 30, 2004 to the KIUC Board for its review and approval, during the budget approval process for the 2005 fiscal year.[25] The goal of this equity management plan process is to determine an optimum mix between built-up equity that should be retained for KIUC's operations and requirements, and equity that should be returned to its members as early as possible and in as large amounts as possible, taking into consideration the following: (1) what is necessary for the prudent, sound and conservative fiscal management of the cooperative; (2) KIUC's ability to comply with regulatory and lender requirements and approvals; (3) the strategic interests of the membership base including, but not limited to, undertaking possible alternative production resources, distribution generation, demand side management programs, and other energy conservation projects; and (4) information received during discussions with the Consumer Advocate. Resolution 34-03 also requires the plan to include long-range financial projections including a projection of KIUC's calendar 2005 normalized operating income and net margins, a projected 2005 balance sheet, projected 2005 TIER and Debt Service Coverage Ratio, and projected cash flows, which shall incorporate the effect of any proposed new depreciation accrual rates, the acquisition of the KPP Facility, and any necessary updated projections of KIUC's administration of the ERAC.

We agree with KIUC's position on this matter, and conclude that Decision and Order No. 18659 should no longer be

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[25]KIUC'S fiscal year is for January 1st to December 31st.

applicable or necessary following the purchase of the KPP Facility by Applicant. However, to address the Consumer Advocate's concerns which we also share, we will require KIUC to submit, as an informational filing, its equity management plan upon its completion in accordance with KIUC Board Resolution 03-34.

E.

Whether any other relief as may be just and reasonable should be granted under the circumstances.

In its Statement of Position, the Consumer Advocate requests the following condition be imposed on KIUC:

> KIUC shall record depreciation expense on the newly acquired KPP generating assets at existing HPUC-approved depreciation accrual rates until the Commission approves any modification to such accrual rates as a result of the depreciation rate study to be submitted by KIUC in 2004.

In connection with this requirement, the Consumer Advocate opposes KIUC's use of a 4.0 per cent depreciation rate for the KPP Facility in its financial projections because that rate was not based on rates previously approved by the commission. Instead, the Consumer Advocate initially argued that the entire KPP Facility be depreciated at the same rate as approved for KIUC's older "Prime Mover" GT-1 and GT-2 units (i.e., 6.04 per cent per year over 16.5 years).

KIUC acknowledged that its use of a 4.0 per cent depreciation rate for the KPP Facility may not have specifically utilized commission-approved rates and that some adjustment may be warranted to be consistent with prior commission precedent. However, KIUC argues that the wholesale application of the 6.04 per cent depreciation rate applicable to the "Prime Mover" GT-1 and GT-2 units to essentially brand new KPP Facility is unreasonable and unnecessary. Instead, KIUC suggests that the acquisition cost of the KPP Facility should be depreciated under various applicable prime accounts pursuant to the existing depreciation study. This method of applying approved depreciation accrual rates would result in a weighted average 4.40 per cent depreciation rate for the KPP Facility. This rate is essentially similar to the composite rate of 4.67 per cent approved by the commission for the existing KIUC system and the overall 20.75 year average useful life utilized in the financial projection in this docket as well as in Docket No. 02-0060. The Consumer Advocate concurs with the applicability of the 4.40 per cent weighted average depreciation rate as proposed by KIUC.[26] At this juncture, we agree with the Consumer Advocate, and conclude that its request to impose on KIUC the above-stated condition concerning depreciation rates should be granted.

V.

SUMMARY OF FINDINGS AND CONCLUSIONS

Upon careful review of the record and based on the parties' representations, the commission finds the purchase of the KPP Facility by KIUC is reasonable and in the public

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[26]See the Consumer Advocate's response to KIUC-IR-1 filed on November 7, 2003.

interest. KIUC's acquisition of the KPP Facility produces tangible financial benefits when looking at the present value of the net cash flows compared to the acquisition price of the KPP Facility. The commission also finds the total acquisition price of $41.75 million to be reasonable. Accordingly, pursuant to Section 2.3.g.2 of the commission's General Order No. 7, the commission finds the KIUC'S commitment of funds, as more fully described in the Application, should be approved.

Second, the commission finds KIUC's proposed financing arrangements, as more fully described in its Application, are reasonable and in the public interest. Thus, pursuant to HRS § 269-17 and § 269-19, (a) the bridge financing and (b) both of the permanent financing scenarios described in the Application as "Scenario 2" and "Scenario 3", respectively, should be approved subject to: (1) Applicant being authorized to select one of the two approved permanent financing scenarios, (2) the permanent financing is closed within twelve (12) months of the closing of Applicant's purchase of the KPP Facility, and (3) the interest rates at closing are no higher than 200 basis points above the applicable interest rates in the financial planning models for "Scenario 2" and "Scenario 3" set forth in Exhibit C of the Application.

Third, the commission finds, by Applicant and KPP entering into the Agreement and by filing this Application notifying the commission and the Consumer Advocate of Applicant's and KPP's intent to terminate the PPA immediately following approval of the subject transaction and closing of the sale of the KPP Facility, Applicant has satisfied the regulatory condition imposed in Ordering Paragraph 5 of Decision and Order No. 16396 and in Ordering Paragraph 1 of Decision and Order No. 18388.

Fourth, the commission finds Decision and Order No. 18659 is no longer applicable or necessary following the purchase of the KPP Facility by Applicant. The commission acknowledges and shares the Consumer Advocate's concerns about the KIUC system's heat rate currently being used, and will require KIUC to file its equity management plan for approval by the commission, upon its completion in accordance with the KIUC Board Resolution 34-03. The commission notes that the equity management plan will allow the commission to review the utility as a whole and will provide the Consumer Advocate with the information it requests such as a projection of KIUC's calendar 2005 normalized operating income and net margins, a projected 2005 balance sheet, projected 2005 TIER and Debt Service Coverage Ratio, and projected cash flows, which shall incorporate the effect of any proposed new depreciation accrual rates, the acquisition of the KPP Facility, and any necessary updated projections of KIUC's administration of the ERAC.

Finally, we find that the Consumer Advocate's request to require that KIUC record depreciation expense on the newly acquired KPP generating assets at existing HPUC-approved depreciation accrual rates until the commission approves any modification to such accrual rates as a result of the depreciation rate study to be submitted by KIUC in 2004 to be reasonable, and conclude that it should be adopted as a condition to this decision and order.

VI.

ORDERS

THE COMMISSION ORDERS:

1. Pursuant to Section 2.3.g.2 of the Commission's General Order No. 7, Applicant's commitment of funds, as more fully described in the Application, is approved.

2. Applicant's proposed financing arrangements are approved, pursuant to HRS § 269-17 and § 269-19. Specifically, (a) the bridge financing and (b) both of the permanent financing scenarios described in the Application as "Scenario 2" and "Scenario 3" respectively, are approved, subject to: (1) Applicant being authorized to select one of the two approved permanent financing scenarios, (2) the permanent financing is closed within twelve (12) months of the closing of Applicant's purchase of the KPP Facility, and (3) the interest rates at closing are no higher than 200 basis points (i.e. 2 per cent) above the applicable interest rates in the financial planning models for "Scenario 2" and "Scenario 3" set forth in Exhibit C of the Application.

3. By Applicant and KPP entering into the Agreement and by filing this Application notifying the commission and the Consumer Advocate of Applicant's and KPP's intent to terminate the PPA immediately following approval of the subject transaction and closing of the sale of the KPP Facility, Applicant has

satisfied the regulatory condition imposed in Ordering Paragraph 5 of Decision and Order No. 16396 and in Ordering Paragraph 1 of Decision and Order No. 18388.

4. Decision and Order No. 18659 is no longer applicable or necessary following the purchase of the KPP Facility by Applicant.

5. Applicant shall submit to the commission and the Consumer Advocate, its equity management plan upon its completion in accordance with KIUC Board Resolution 34-03.

6. Applicant shall record depreciation expense on the newly acquired KPP generating assets at existing commission approved depreciation accrual rates until the commission approves any modification to such accrual rates as a result of the depreciation rate study to be submitted by Applicant in 2004.

7. Applicant shall conform to all of the commission's orders set forth above. Failure to adhere to our orders constitutes cause for the commission to void this decision and order, and may result in further regulatory actions as authorized by law.

DONE at Honolulu, Hawaii this 26th day of November, 2003.

PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII

By
Carlito P. Caliboso, Chairman

By
Wayne H. Kimura, Commissioner

By
Janet E. Kawelo, Commissioner

APPROVED AS TO FORM:

Kevin M. Katsura
Commission Counsel

03-0223.eh

CERTIFICATE OF SERVICE

I hereby certify that I have this date served a copy of the foregoing Decision and Order No. 20691 upon the following parties, by causing a copy hereof to be mailed, postage prepaid, and properly addressed to each such party.

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DATED: November 26, 2003